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Zero-based trade for CPG leaders

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Five steps for raising the impact of your trade promotions

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Executive summary

The next wave of profitability for consumer packaged goods (CPG) companies will come from zero-based trade (ZBT). This adaptation of zero-based budgeting goes beyond cost management of trade promotion. It helps manufacturers rethink their patterns of spending and increase the profitability of this all-important way of reaching end consumers in retail stores. Trade promotion, which directs shopper awareness at the point of sale, is a valuable strategic capability. In the annual expenses of a CPG company, it typically ranks second; only the cost of goods sold is greater.

ZBT represents a five-step process for raising the impact of that spending. The first step is to diagnose your situation and look for previously unseen opportunities for improvement. Second, develop trade promotion strategies that are aligned with your business strategy, reflecting both the financial returns you expect from your trade promotion investment and the level of freedom you have to redeploy it. Third, employ trade optimization levers — budgeting, pricing, analytic planning, and post-event analysis — to implement these new strategies. Fourth, bring your overall trade budgets in line with your new approach. Finally, give this new ZBT practice the enabling capabilities needed to sustain it over time. Together, these steps add up to a new overall trade promotion strategy that can yield millions in savings for your CPG company and give it a customer-facing competitive edge.

Introducing zero-based trade

After it was spun off from its parent company, the leaders of a US$4 billion food manufacturer decided to pursue a two-pronged growth strategy. They would revitalize their core brands, which were mostly snacks and lunch foods popular throughout North America. They would also aggressively expand into adjacent categories, which would mean ramping up investment in innovation and advertising. But where would they get the necessary funding? The answer was optimizing their trade promotion spending.

Many people outside the industry aren't aware of the role that trade spending plays in a consumer packaged goods (CPG) manufacturer's bottom line. In the annual expenses of a CPG company, it typically ranks second; only the cost of goods sold is greater. Bringing this factor under control can make a growth strategy viable. Thus, when a method shows promise for cutting back the costs of trade spending — and, in the process, making it more strategically effective — it's worth consideration.

A few CPG early adopters are implementing this type of method: a clean-sheet approach called zero-based trade (ZBT) that can help you put in place an overall trade promotion spending strategy. ZBT is an adaptation of zero-based budgeting (ZBB), a method with a long-standing track record of success in other fields. Early efforts in ZBT have shown that it can systematically boost the return on investment (ROI) of a CPG company's trade spending by 10 to 20 percent. It does this while making it easier for that company to build stronger brands, enhance innovation, increase margins, and drive shareholder returns.

The key to ZBT is understanding the potential strategic value of trade promotion. Often managed by the sales function, this is the body of activity that brings products to the attention of consumers at the moment of purchase. It includes promotional events, such as price discounts, displays, demonstrations, and the like, conducted in conjunction with retail merchants. In the U.S. alone, CPG trade spending exceeds $200 billion annually. Company executives tend to recognize its importance. It is typically the second-largest line item

on their P&Ls (behind the cost of goods sold), and it consumes about 20 percent of their gross sales.

Yet, as essential as trade spending is to the success of CPG manufacturers, it is also something of a drag on their profits. Sixty-three percent of the CPG executives who were surveyed in 2016 for Strategy&'s biannual benchmarking study of trade management practices admitted that their current levels of trade spending are unsustainable. Worse, only 19 percent of them reported being able to reduce trade spending as a percentage of sales over the past two years. All of that changes, far more rapidly than expected, when zero-based trade enters the scene.

A better way to budget

The value of zero-based trade is evident from its roots in zero-based budgeting. This more general form of cost control has taken on greater cachet in the past few years because of its use by many private equity firms. In line with the ZBB revival, a number of CPG companies are using it to cut expenses, notably selling, general, and administrative costs. However, most of these companies could be more strategic in the way they apply ZBB. They currently orient it toward costs without fully recognizing the ways that they can use it to grow stronger.

Moreover, ZBB has rarely been applied to trade spending. Therein lies a rich opportunity, especially with the growth potential inherent in more effective product promotion.

Conventional trade spending effectiveness is undermined by the budgeting process at many CPG companies. Last year's spending is used to set the baseline for this year's budget; this year's spending sets the baseline for next year's budget; and so on. This results not only in ever-larger trade budgets but also in an ever-more-tenuous connection between trade spending and the ROI of the activities it funds. Indeed, the executives in one survey by the Nielsen Company reported that 67 percent of their trade promotions do not break even and 22 percent of them actually destroy value.

The zero-based alternative applies a clean-sheet approach to trade promotion spending. As with all zero-based methods, you start fresh each fiscal year, evaluating all costs in line with projected ROI. But ZBT goes beyond conventional zero-based budgeting, because sharp-penciled attention to the bottom line, while necessary, cannot in itself fix trade spending. Indeed, heedlessly resetting trade budgets to zero could destroy valuable relationships with retailers and devastate brands. Instead, you bring robust trade optimization insights into your budgeting process, in a way that supports the broader strategies of your brands and retailers. This approach consistently delivers significant returns.

Like any truly robust capability, zero-based trade requires hard work and investment. You institute ZBT in a measured way, using a five-step approach: Diagnose your situation; develop a strategy to optimize trade spending across your portfolio of products; use key levers to optimize trade spending on a day-to-day level; rightsize trade budgets; and then, with proven gains in hand, build ZBT into a sustainable capability that your competitors cannot match.

Step 1: Diagnose your situation

Your first task is to assess current practices and estimate the benefits of a better approach. Conduct a clear-eyed examination of your company's current trade promotion practices, including the trade marketing team's organizational structure and related systems and processes. Look at the rigor used in allocating trade budgets, setting prices, and developing spending plans for individual retailers, and the extent to which the results of these plans are measured and evaluated. Each element — budgeting, pricing, planning, and post-event analysis — offers profit improvement potential. Gauging the gap between current practices and ZBT can help you determine how much benefit ZBT can deliver.

Then, establish a current trade spending baseline by deconstructing your existing budgets into their underlying components — that is, the activities they will fund, such as "everyday low price" agreements, merchandising events, slotting fees, and list price subsidies. This clarifies the potential gains that you could capture by optimizing each type of activity.

Finally, measure your current return on investment for trade spending. Approaches to ROI measurement vary in effort, precision, and insight. A typical light approach — time-effective, but relatively imprecise — might involve measuring the incremental sales volume for a group of promoted products over a predetermined period of time. Use that to calculate the overall ROI per year, based on the amount of spending required and the variable contribution of those products. A more comprehensive, accurate, and insightful method, which entails considerably more effort, is event-level ROI analysis, in which you conduct postmortems on a representative cross-section of trade promotion events.

The best approach depends on your company. If you already have a robust post-event analysis capability in place, that may be the way to go, especially if there is existing ROI data. On the other hand, a company that is at the beginning of its trade journey might opt for a lighter touch and a less detailed estimate of the potential gains from ZBT.

Step 2: Develop your trade optimization strategy

Next, you should look across your portfolio of products and develop fit-for-purpose trade optimization strategies for key categories and brands. These strategies should take into account three key factors: the strategic context for trade promotion, the ROI of existing spending, and your "trade power": the degree of freedom you have in spending this money, based on your market power relative to other manufacturers and your clout with retail partners.

It is important to understand the role that trade promotion plays in enabling your brand portfolio strategy. For instance, it can be used to encourage customers to try new products or switch from one established brand to another. You should also understand the role that trade plays in supporting the strategies of each of your retailers. Some retailers pursue everyday low price strategies and expect the majority of trade spending to support these price points; others pursue high–low strategies and expect to drive numerous merchandising promotions with this spending.

Given the significant amount of trade spending, it is important to understand where these investments are driving positive returns and should be continued or increased, and where they are losing money and should be redeployed. Information from the diagnostic in the previous step helps to inform these decisions.

The greater your trade power, the greater freedom you have to set the terms.

Determining your trade power relative to other manufacturers in a given category (or other logical grouping of products) and relative to your retail customers sets the gauge for the level of freedom you have to set trade terms; the greater your trade power, the greater freedom you have to set the terms. Frito-Lay, for instance, has considerable power relative to other manufacturers in the salty snacks category, but the extent to which it can exert this power varies by retailer. It probably can flex its muscle to set trade terms with smaller retailers like Piggly Wiggly with little risk, but it needs to be more cautious with larger retailers like Walmart that can flex their own muscles in negotiating trade terms.

When you understand these three factors — strategic context, ROI, and trade power — you can determine the best strategy for optimizing trade spending in each category (or other grouping of products) at each retailer using a matrix-based framework (*see Exhibit 1, next page*).

Exhibit 1
A framework for trade spending optimization

Source: Strategy& research

In situations where you have high trade power, you have more options at your disposal, as you can determine the right balance of trade spending relative to other investment alternatives (shopper marketing, advertising, retailer-specific items, etc.) based on what will drive the highest return and achieve your desired strategic objectives. If greater returns can be achieved by one of the other alternatives, you have the power to remove trade dollars and deploy this money more effectively elsewhere.

On the flip side, in situations where you have less trade power, you have fewer options for how to optimize your investment, as it is less feasible to reduce trade spending and redeploy it in other areas without suffering backlash from retailers. Thus, you will typically need to maintain trade at existing levels in these areas and seek to optimize returns through trade-related levers.

These trade strategies ultimately need to be translated into a budgeting approach (i.e., funding structure and rates) that both works for the business and is consistent with prevailing regulations governing manufacturer and retailer funding practices.

Step 3: Optimize trade using key levers

In this step, having developed your trade optimization strategies by customer across your product portfolio, you translate those strategies into everyday activity, conducted by people throughout your organization. This requires you to make changes across four key levers:

- The division of budgets across retailers, changing from conventional year-over-year customer funding to performance-based funding

- The approach to pricing, moving from ad hoc to disciplined pricing that reflects the interdependency of base and promotion pricing strategies and the need to maintain desired price gaps — brand, channel, competitor, etc. — while running a promotion

- The method of planning for each major retail customer, changing from copy-and-paste planning to analytically rigorous bottom-up customer planning

- The analysis of performance, shifting from running the same events blindly to gaining a detailed understanding of which events worked, which didn’t, and why

A performance-based structure that varies funding based on objective, transparent incentives is a powerful tool for aligning manufacturers and their customers. These programs are typically initiated by CPG companies, but you'll find that retailers participate wholeheartedly if they understand the value they create. The structured variability provided by such programs offers several benefits: It directs investment toward the best opportunity; it reduces negotiation time, both internally with field sales ("I need more money to hit my target") and externally with customers ("I need more money to fund this program"); it elevates the discourse between manufacturer and customer from trade dollars to business drivers; and it incorporates both historical and future measures of performance.

Trade promotion is a key enabler for translating list prices into differentiated retail prices by channel and customer. The deployment of trade dollars affects multiple price points. In some cases, it can be used across the board with all customers to set an adjusted list price (for example, when a manufacturer has increased its list price but subsequently dealt the difference back to retailers in trade). Trade spending can also be used to lower the everyday shelf price or to achieve temporary price reductions during promotions. The frequency and depth of these price points drive the average retail price for a product at a given retailer. A disciplined approach is required to manage these prices in a coherent way across the market and ensure that price points are competitive, reflect the right value to the consumer, and do not leave any money on the table. Several factors need to be considered, including key price differences (among different pack sizes, among brands in your own portfolio, across channels and customers, and relative to competitors), brand strategies, customer strategies, and required margins for both you and the retailer.

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To achieve an analytically rigorous, bottom-up planning approach, you must equip customer-dedicated field and pricing teams with analytical planning tools powered by predictive models that produce accurate results. You must align your incentive programs with accountability targets to drive focus and buy-in. You must also create a center of excellence to support the teams. With these measures in place, the outcomes include more rigorous base and incremental consumption-based planning, new processes embedded in the organization, greater collaboration across sales teams, better-informed joint business planning discussions with customers, and creation of more profitable customer plans with improvement in event-level ROI based on more informed decisions.

Trade spending optimization also requires a capacity for post-event analysis that enables your sales teams to move from data to insight to action. To conduct this type of analysis in a timely and holistic way,

your post-event analysis tool needs to automate as much of the data collection and integration activities as possible while still providing a mechanism for human intervention (to ensure that data is both cleansed and enriched). Your company must be able to calculate ROI and identify the cause of superior returns (calling out one-off and black swan outcomes). In turn, your sales teams must be able to surface insights from this information and close the loop using those insights to act in ways that drive incremental growth and optimize future spending.

Step 4: Rightsize the budget

With everything you have learned from the previous steps — including insights on trade spending baseline, trade power, and the return on investment for your customer plans — you can rightsize the existing trade budget in line with your needs. Your goal is to identify where trade spending should be reduced or eliminated, where it should be maintained as is, and where you need to add investment.

There are two basic methods for rightsizing your trade spending budget. The first is list price rationalization — a method of overcoming the inconsistencies of the past. Over time, you have probably built up a pattern of list price subsidies that you grant across the board to retailers. Now you can fix this chronic problem by rationalizing list prices and removing the corresponding trade spending. Although this does not affect net sales (the reduction in gross sales due to a lower list price is generally offset by the reduction in trade), it does reduce complexity and takes unnecessary trade dollars out of the system.

Before reducing any specific list price subsidy, weigh the positive and negative consequences.

Before reducing any specific list price subsidy, weigh the positive and negative consequences. On the plus side, list price rationalization can eliminate the inappropriate use of subsidies by retailers and can lead to improved payment terms based on lower list prices. However, it also could lead to your removal from preferred retailer programs such as “yellow tag” price designations (if the reduced trade as a percentage of sales ratio falls below a retailer’s prescribed threshold).

The other method is addressable trade rightsizing. This involves the application of insights from the work you did in the first three steps. When done systematically, this type of budgeting effort can drive significant profit improvement. The term “addressable” refers to the funding associated with everyday low pricing promotion or merchandising — funding where customer planning and post-event analysis can identify the most effective and efficient trade spending. Funding that is out of scope or unaddressable, however, is what results when you have list price distortions, spend committed to retailers (often contractually) that cannot be changed, or spend that does not impact consumers directly.

When we analyzed the trade power and trade ROI of 30 major food and beverage manufacturers in 80 categories, there were significant potential reductions in trade spending in 25 percent of the categories. Indeed, in a world where private equity companies are taking cost cutting to new levels of competitive advantage, there are a growing number of success stories to emulate, where spending cuts that would have been regarded as impossible before are now recognized as ways to build a company's long-term strength.

As with list price rationalization, particular spending reductions should be "stress tested" using secondary filters to determine their feasibility. The key factors in a stress test include the ratio of trade spending to sales, the effect that reductions in one category may have on other categories, and the impact of the reduction on the customer relationship. Addressable trade rightsizing also should be considered in conjunction with other improvement levers, such as innovation, price-pack architecture, and advertising, before any action is taken. With all this information in hand, a company can accurately assess the consequences of reducing trade spending in a category — and can quantify the reduction.

Step 5: Build a sustainable capability

To reap the full benefits of ZBT, you must embed it as a sustainable capability. This requires several types of enabling mechanisms within your company. There must be new processes such as performance-based funding, strategic pricing, analytical planning, and and post-event analysis (PEA). Organizational supports are needed, such as incentives, clear roles and responsibilities, and appropriate skills and training. Robust analytic tools including product elasticities, volume response and decomposition models, and profitability metrics must be available. And there must be underlying structures in place, such as trade promotion management (TPM), trade promotion optimization (TPO), and PEA systems.

In the end, succeeding at building such a capability requires an overall transformation driven by senior leadership. These leaders must establish the vision, set clear goals, empower champions to drive the change and build momentum, and ultimately hold the organization accountable for achieving the stated objectives.

Conclusion

Zero-based trade is a complex capability; it requires a lot of work to get right. But there are not many other opportunities in a typical CPG business to systematically reduce costs and capture benefits of such significant magnitude. Moreover, the dramatic bottom-line value that ZBT can produce is just one payoff. When the newly independent CPG company described at the beginning of this report implemented ZBT, it reduced its trade spending by $60 million two years into a three-year program (with more savings expected per year as the program continues to develop). That significant bottom-line impact is typical. There are additional rewards in the form of higher trade ROI and the improved margins and market share that go with it. But perhaps the best reward of all is the opportunity to reinvest the payoffs from ZBT in other areas, such as new and innovative products and more effective marketing.

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